Tax Treatment of Thrift Savings Plan Payments Made Under Qualifying Orders

Except as noted below, a payment made by the Thrift Savings Plan (TSP) pursuant to a qualifying order is taxable income for Federal income tax purposes in the year the payment is made.

Qualifying orders are **retirement benefits court orders, legal processes,** and **child abuse orders**. Retirement benefits court orders are issued pursuant to a divorce, annulment, or legal separation action, and award an amount to be paid from a participant's TSP account to a current (including separated) or former spouse, a dependent, or an attorney for a spouse or dependent. Legal processes are issued pursuant to state law and garnish a participant's account to enforce a current child support or alimony obligation. Child abuse orders are issued to garnish a participant's account to satisfy a judgment related to the abuse of a child.

We are required by law to provide you with this tax notice, which summarizes tax rules applicable to TSP payments made under **qualifying orders**. Because the tax rules are complex, however, you may wish to consult a tax advisor before you make any decision that might be affected by them.

1. Tax Liability

The tax liability for payments made under qualifying orders depends upon whether the person being paid is either a current or former spouse or someone else. If payment is made to a current or former spouse, it will be taxable income to that individual. However, if payment is made to someone else (such as to a child for child support or to an attorney for payment of attorney's fees), it will be taxable income to the TSP participant from whose account the payment is made.

If you are a current or former spouse, you may want to consider whether you should transfer all or part of your payment to a "traditional IRA" or to an eligible employer plan.[1] If you are also currently a TSP participant, you may be able to transfer the payment to your TSP account. (*See Section 3 of this notice.*) You should also consider whether you can use the 10-year tax option. (*See Section 5 of this notice.*)

Special Note for Uniformed Services Accounts

TSP accounts for members of the uniformed services may include contributions from combat zone pay. Combat zone pay is exempt from Federal income taxes; therefore, TSP contributions from combat zone pay are also exempt from Federal income taxes when they are subsequently distributed from a TSP uniformed services account pursuant to a qualifying order. (This is not true for the earnings attributable to contributions from combat zone pay; all earnings are taxable when they are distributed from a TSP account.)

The TSP will make all payments from a uniformed services account on a *pro rata* basis from both taxable and tax-exempt balances unless the court order or legal process directs otherwise. A payment made under a qualifying order will therefore include taxable and tax-exempt balances if the account includes contributions from combat zone pay. If you are responsible for the Federal income taxes on the court order payment, Internal Revenue Service (IRS) Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., which the TSP provides you, will separately state the total amount and the taxable amount of the court ordered payment. (*See Section 4 of this notice.*)

Unless otherwise noted, the following discussion applies **only** to the taxable portion of a payment made pursuant to a qualifying order.

2. Tax Withholding

The Federal income tax withholding and rollover rules that apply to a payment made under a qualifying order also depend upon whether the payment is made to the current or former spouse or to someone else.

Tax Withholding on Payments Made to Current and Former Spouses

A payment to a current or former spouse under a qualifying order is considered an **eligible rollover distribution**. The following tax withholding rules apply:

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[1] A "traditional IRA" is an individual retirement account described at § 408(a) of the Internal Revenue Code (I.R.C.) or an individual retirement annuity described at I.R.C. § 408(b). (It does not include a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA).) An "eligible employer plan" includes a plan qualified under I.R.C. § 401(a), including a § 401(k) plan, profit-sharing plan, defined benefit plan, stock bonus plan, and money purchase plan; an I.R.C. § 403(a) annuity plan; an I.R.C. § 403(b) tax-sheltered annuity; and an eligible I.R.C. § 457(b) plan maintained by a governmental employer.

- There is mandatory tax withholding of 20% on any amounts of $200 or more that the current or former spouse receives directly from the TSP in a single year. This applies to alimony payments as well as to payments awarding a portion of a TSP participant's account in a divorce, annulment, or legal separation proceeding. The 20% is tax withholding, not actual tax due; therefore, when the current or former spouse files an annual Federal income tax return, he or she may be entitled to a refund of a portion of this amount, or may be required to pay an additional amount.
- A current or former spouse can avoid the 20% withholding on all or any portion of an eligible rollover distribution by asking the TSP to transfer that amount to a traditional IRA or to an eligible employer plan. However, the recipient **cannot** avoid the 20% withholding on any amount that he or she elects to receive directly, even if the payment is then rolled over to a traditional IRA or eligible employer plan. (*See Section 3 of this notice.*)
- A current or former spouse may elect to have an amount withheld in addition to the 20% withholding by completing Line 3 of IRS Form W-4P, Withholding Certificate for Pension or Annuity Payments.[2] The recipient should submit this form to the TSP Service Office at the address provided at the end of this notice. Line 1 and Line 2 are not valid elections for this type of payment.
- There is no withholding if the total payment to the current or former spouse is less than $200. However, the recipient can still elect withholding for any payment of less than $200 which is made under a qualifying court order by completing Line 3 of IRS Form W-4P.

Tax Withholding on Payments (Including Child Support Payments) Made to Persons Other Than Current or Former Spouses

If you are a TSP participant and a payment is made under a qualifying order from your TSP account to someone other than your current or former spouse (for example, to a child for child support or to an attorney for attorney's fees), this payment is taxable income to **you**. Under the Internal Revenue Code (I.R.C.), this payment is treated as a **non-periodic payment** for Federal income tax withholding purposes.

The TSP will withhold 10% for Federal income tax from this payment unless the TSP Service Office receives from you IRS Form W-4P, Withholding Certificate for Pension or Annuity Payments.

If you submit IRS Form W-4P, you may elect:

- to have no Federal income tax withheld by completing Line 1 of Form W-4P; or
- to have an amount withheld in addition to the 10% by completing Line 3 of Form W-4P.

Line 2 of Form W-4P is not a valid election for this type of payment.

Special Note for Nonresident Aliens

Special tax withholding rules apply to TSP payments made to nonresident aliens. For a detailed explanation of how these rules apply to you, please read the TSP tax notice "Tax Treatment of Thrift Savings Plan Payments to Nonresident Aliens and Their Beneficiaries." You can obtain a copy of the notice from the TSP Web site (www.tsp.gov) or by calling or writing the TSP Service Office.

A **nonresident alien** is an individual who is neither a citizen nor a resident alien in the United States.[3] A **resident alien** is a non-citizen who is or was a lawful permanent resident of the United States during any part of a calendar year. An alien may also be considered a U.S. resident if the individual meets the IRS "substantial presence" test for a calendar year.[4] For information on residency status and the tests for residency, you may obtain IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, or IRS Publication 519, *U.S. Tax Guide for Aliens*.

Other Tax Withholding Information

If you are responsible for the Federal income tax associated with the court-order payment and do not have enough Federal income tax withheld from your payment, you may be responsible for paying estimated tax. You may also incur penalties under the IRS estimated tax rules if your withholding and estimated tax payments are not sufficient.

If you elected to have no taxes withheld (by submitting IRS Form W-4P) and you decide before the payment is made that you do want taxes withheld, you may revoke your prior decision by completing another Form W-4P and writing "Revoked" on Line 1 of the form. Taxes will then be withheld at the rate set by law.

You can request additional withholding for a court-ordered payment by completing Line 3 of IRS Form W-4P. If you complete Line 3 of IRS Form W-4P and the total amount of the withholding equals or exceeds the amount of your payment, your entire payment will be withheld.

[2] If you have both a civilian TSP account and a uniformed services TSP account, you must submit a separate IRS Form W-4P for each account.

[3] The "United States" includes the 50 States and the District of Columbia.

[4] This is commonly referred to as the "green card" test.

The TSP does not withhold for state, city, county, or other local income tax. Therefore, you should consult your tax advisor or relevant state or local taxing authorities regarding any potential tax obligations to them.

3. Transferring or Rolling Over a TSP Payment Made to a Current or Former Spouse

If you are a current or former spouse receiving a TSP payment made under a qualifying order, all or any part of your payment can either be transferred or rolled over to a traditional IRA or an eligible employer plan. This permits you to postpone paying tax on that amount until you withdraw the money from the IRA or the plan. However, distributions from the IRA or plan to which the transfer or rollover is made may be subject to different plan rules and tax consequences from those that apply to distributions from the TSP.

A **transfer** occurs when you instruct the TSP to send all or part of your payment directly to a traditional IRA or eligible employer plan instead of issuing it to you. Mandatory 20% Federal income tax withholding does not apply to an amount that the TSP transfers directly to a traditional IRA or eligible employer plan; **however, it does apply to any payment made to you, even if you then roll it over.**

If you are also currently a TSP participant (active or separated), payment to you under a qualifying order may be transferred into your TSP account. In order to be eligible for such a transfer, you must not be receiving monthly payments if you are separated from Government service.

A **rollover** occurs when the TSP makes a distribution to you (which includes the amount of the payment you receive plus the amount of tax withheld) and you deposit any part of that distribution into a traditional IRA or eligible employer plan within 60 days of the date you receive it.

In deciding whether to choose a transfer or a rollover, you should consider the following:

- You must pay Federal income tax on any part of the payment that you do not transfer or roll over.
- Because all eligible rollover distributions of $200 or more made directly to you are subject to mandatory 20% withholding, you must pay Federal income tax on the amount withheld for taxes — even if you roll over the amount you receive — unless you deposit personal funds into your traditional IRA or eligible employer plan equal to the amount withheld. (If you do this, you may receive a refund of the taxes withheld, but you cannot wait until you receive a refund of the withheld amount to complete a rollover.)

Therefore, if you do not want to use personal funds to make up the amount withheld, you should choose to have the TSP transfer the payment to your traditional IRA or eligible employer plan directly, instead of rolling it over to your IRA or plan yourself.

If you are not a current or former spouse of the TSP participant, you cannot transfer or roll over your TSP payment.

Special Note for Uniformed Services Accounts

If you are a current or former spouse receiving a TSP payment containing a tax-exempt balance (i.e., contributions from combat zone pay), the tax-exempt portion of your payment may be transferred or rolled over into a traditional IRA or transferred into certain eligible employer plans, but only if the IRA or plan accepts tax-exempt balances.

If you transfer or roll over a tax-exempt balance into a traditional IRA, it is your responsibility to keep track of these amounts and report them to the IRS on the appropriate form so that the nontaxable portions of any future distribution(s) from your IRA can be determined.

In contrast, you may only transfer (not roll over) a tax-exempt balance to an eligible employer plan; you cannot first transfer or roll over a tax-exempt balance into a traditional IRA and then roll over that amount into an employer plan. The only types of eligible employer plans that can accept a transfer of tax-exempt balances from the TSP are plans qualified under I.R.C. § 401(a) and I.R.C. § 403(a) annuity plans; however, a plan is not legally required to accept such a transfer.

If the IRA or plan does not accept tax-exempt balances, the tax-exempt portion of the intended transfer will be removed from the amount that is being transferred and will be paid directly to you. Tax-exempt balances in a uniformed services TSP account may not be transferred into a civilian TSP account.

4. Tax Reporting

The TSP will report to the IRS all payments made under a qualifying order, including all amounts transferred by the TSP at the request of current or former spouses to traditional IRAs or eligible employer plans. The TSP will also report TSP payments and transfers to the state in which our records show the party responsible for taxes resided (or, for members of the uniformed services, their state of legal residence as reported by their service) at the time the payments were made, if that state has an income tax.

In January of the year that follows the TSP payment, the TSP will send Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., to the party responsible for taxes. If you are that party, you should include the taxable amount reported on Form 1099-R as income on your individual income tax return for the year in which payment was made. **You should keep the TSP Service Office informed of any address changes until you receive this tax information.**

5. Ten-Year Tax Option

If you are a current or former spouse and you receive a TSP payment pursuant to a qualifying order, your payment qualifies as an **eligible lump sum distribution**. You may be able to lower the income tax you pay by using the **10-year tax option**.

An **eligible lump sum distribution** is one in which the entire portion of the participant's account to which you are entitled is distributed to you within one year (the calendar year, for most taxpayers), regardless of whether the distribution occurs in one or more payments.[5] With the **10-year tax option**, your eligible lump sum distribution is taxed as if it were paid to you over 10 tax years.

The following rules apply to the 10-year tax option:

- The 10-year tax option is available only if the participant was age 50 before January 1, 1986.
- The participant must have been an **active participant** in the TSP for at least 5 years before the year in which your distribution is made. A participant is considered an active participant during a year if either the participant or the participant's agency or service made a contribution to the participant's TSP account during that year.
- You must use the 10-year tax option for all eligible lump sum distributions that you receive as a current or former spouse of the participant in the same tax year. This includes an eligible lump sum distribution from any plan described in I.R.C. § 401(a) or § 403(a) which is maintained by the participant's employer.
- You must use the tax rates in effect in 1986.
- If you transfer or roll over all or any part of your distribution, you cannot use the 10-year tax option.

You can elect the 10-year tax option by filing IRS Form 4972, Tax on Lump Sum Distributions, with your annual income tax return.

If you are not a current or former spouse of the TSP participant, you cannot use the 10-year tax option for your TSP payment made pursuant to a qualifying order.

6. TSP Service Office Information

If you have any questions regarding this notice, please contact the TSP Service Office at (504) 255-6000 (TDD: (504) 255-5113), or write to:

TSP Service Office
National Finance Center
P.O. Box 61500
New Orleans, LA 70161-1500

If contacting the Service Office in writing, include both your name and Social Security number, if applicable, and the name and Social Security number of the participant. The Social Security numbers are important in identifying the TSP account to which the payment relates.

[5] If the participant has two accounts, the "entire portion" refers to the entire portion you are entitled to receive from both the participant's civilian *and* uniformed services TSP accounts.